INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
February 06, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

[For the transition period from to]

Commission File No. 0-31157

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

(Exact name of registrant as specified in its charter)

PENNSYLVANIA (State or other jurisdiction of incorporation)	**23-2507402** (IRS Employer Identification No.)
720 Pennsylvania Drive, Exton, Pennsylvania (Address of principal executive offices)	**19341** (Zip Code)

(610) 646-9800

(Registrant s telephone number, including area code)

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 day.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

o Large accelerated filer	x Accelerated filer
o Non-accelerated filer (Do not check if a smaller reporting company)	o Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of February 4, 2009, there were 16,743,209 shares of the Registrant s Common Stock, with par value of $.001 per share, outstanding.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	December 31, 2008	September 30, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 33,725,670	$ 35,031,932
Accounts receivable, net	6,871,967	4,218,443
Inventories	7,668,241	9,361,257
Deferred income taxes	346,581	414,636
Prepaid expenses and other current assets	1,249,384	1,406,260
Total current assets	49,861,843	50,432,528
Property and equipment, net	8,816,417	8,958,346
Other assets	460,010	505,840
Total assets	$ 59,138,270	$ 59,896,714
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Current portion of capitalized lease obligations	$ 9,908	$ 9,908
Accounts payable	2,009,655	2,349,981
Accrued expenses	2,812,888	5,130,463
Deferred revenue	374,033	450,923
Total current liabilities	5,206,484	7,941,275
Note payable	4,335,000	4,335,000
Long-term portion of capitalized lease obligations	35,041	37,633
Deferred revenue	99,870	114,075
Deferred income taxes	346,581	414,636
Other liabilities	277,030	249,969
Total liabilities	10,300,006	13,092,588
Commitments and contingencies		
Shareholders Equity:		
Preferred stock, 10,000,000 shares authorized, $.001 par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at		

December 31, 2008 and September 30, 2008

Common stock, $.001 par value: 75,000,000 shares authorized, 18,179,659 and 18,177,024 shares issued at December 31, 2008 and September 30, 2008		18,179		18,177
Additional paid-in capital		45,978,710		45,767,960
Retained earnings		21,976,001		20,152,615
Treasury stock, at cost, 1,445,510 shares at December 31, 2008 and September 30, 2008		(19,134,626)		(19,134,626)
Total shareholders equity		48,838,264		46,804,126
Total liabilities and shareholders equity	$	59,138,270	$	59,896,714

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three months ended December 31, 2008	2007
Net sales:		
Product	$ 8,889,118	$ 3,899,788
Engineering - modification and development	1,686,228	835,859
Total net sales	10,575,346	4,735,647
Cost of sales:		
Product	4,995,094	2,770,099
Engineering - modification and development	260,079	888,960
Total cost of sales	5,255,173	3,659,059
Gross profit	5,320,173	1,076,588
Operating expenses:		
Research and development	1,280,501	1,740,668
Selling, general and administrative	2,359,307	5,935,906
Total operating expenses	3,639,808	7,676,574
Operating income (loss)	1,680,365	(6,599,986)
Interest income	201,086	589,361
Interest expense	(35,474)	(50,539)
Other income	50,073	
Income (loss) before income taxes	1,896,050	(6,061,164)
Income taxes expense (benefit)	72,664	(1,939,223)
Net income (loss)	$ 1,823,386	$ (4,121,941)
Net income (loss) per common share:		
Basic	$ 0.11	$ (0.24)
Diluted	$ 0.11	$ (0.24)
Weighted average shares outstanding:		
Basic	16,734,149	16,893,547
Diluted	16,769,933	16,893,547

The accompanying notes are an integral part of these statements.

INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the Three Months Ended December 31 2008	For the Three Months Ended December 31 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,823,386	$ (4,121,941)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: Depreciation and amortization	259,530	245,239
Share-based compensation expense:		
Stock options	143,644	129,136
Nonvested stock awards	50,089	50,000
Tax benefit from share-based arrangements:		
Stock options		10,439
Nonvested stock awards	17,019	6,286
Excess tax benefits from share-based payments arrangements		(9,685)
(Gain) loss on disposal of property and equipment	260	(3,000)
Excess and obsolete inventory expense	557,312	
Deferred income tax benefit		(448,586)
(Increase) decrease in:		
Accounts receivable	(2,653,524)	1,139,366
Inventories	1,135,704	(273,435)
Prepaid expenses and other current assets	155,866	(1,540,588)
Other non current assets	3,000	(6,180)
Increase (decrease) in:		
Accounts payable	(340,326)	1,014,465
Accrued expenses	(1,654,208)	(984,307)
Income taxes payable	(635,296)	
Deferred revenue	(91,095)	(405,484)
Net cash used in operating activities	(1,228,639)	(5,198,275)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(75,031)	(158,549)
Proceeds on sale of property and equipment		3,000
Net cash used in investing activities	(75,031)	(155,549)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options		14,933
Repayment of capitalized lease obligations	(2,592)	(2,414)
Excess tax benefits from share-based payments arrangements		9,685
Net cash (used in) provided by financing activities	(2,592)	22,204
Net decrease in cash and cash equivalents	(1,306,262)	(5,331,620)
Cash and cash equivalents, beginning of period	35,031,932	49,151,078
Cash and cash equivalents, end of period	$ 33,725,670	$ 43,819,458
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for interest	$ 25,374	$ 40,439
Cash paid for income tax	$ 690,942	$
Cash received for income tax refunds	$	$ 4,593

The accompanying notes are an integral part of these statements.

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Innovative Solutions and Support Inc.
Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting Policies

Description of the Company

Innovative Solutions and Support, Inc. (the Company) was incorporated in Pennsylvania on February 12, 1988. The Company s primary business is the design, manufacture and sale of flat panel display systems, flight information computers and advanced monitoring systems for military, government, commercial air transport and corporate aviation markets.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission in accordance with the disclosure requirements for the quarterly report on Form 10-Q and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete annual financial statements. In the opinion of the management of the Company, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to fairly state the results for the interim periods presented. The condensed consolidated balance sheet as of September 30, 2008 is derived from audited financial statements. Operating results for the three months ended December 31, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2009. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of the Company included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

Our condensed consolidated financial statements include the accounts of our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

Preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Cash and Cash Equivalents

Highly liquid investments purchased with an original maturity of three months or less are classified as cash equivalents. Cash equivalents at December 31, 2008 and September 30, 2008 consist of funds invested in money market accounts with financial institutions.

Property and Equipment

Property and equipment is stated at cost. Depreciation is provided using an accelerated method over estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the airplane and manufacturing facility, which are depreciated using the straight-line method over estimated useful lives of ten years and thirty-nine years, respectively. Major additions and improvements are capitalized, while maintenance and repairs that do not improve or extend the life of assets are charged to expense as incurred.

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Also, in general, long-lived assets to be disposed of should be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of

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the asset to its fair value. The estimation of fair value is generally measured by discounting expected future cash flows. No impairment charges were recorded during the quarter ended December 31, 2008 or 2007.

Revenue Recognition

The Company recognizes revenue when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable, and collectability is reasonably assured.

The Company enters into sales arrangements with customers that, in general, provide for the Company to design, develop, manufacture and deliver flight information computers, large flat-panel displays, and advanced monitoring systems that measure and display critical flight information, including data relative to aircraft separation, airspeed, altitude as well as engine and fuel data measurements. The Company may also enters into sales arrangements for the provision of engineering and design services that do not result in the delivery of products.

For sales arrangements where software is not more than incidental, the Company identifies all goods and/or services that are to be delivered separately under the sales arrangement and allocates revenue to each deliverable based on relative fair values. In general, fair values are established based on the prices charged when sold separately by the Company, or based on pricing information in the marketplace for similar products or services. Deliverables typically include product design and development services, products, and may include maintenance services, extended warranties, or other deliverables. For sales arrangements that contain software that is more than incidental and which include multiple elements, revenue is allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value. The allocated revenue for each deliverable is recognized using revenue recognition methods applicable to the specific deliverable.

The Company recognizes its engineering and design contracts using either the proportional performance method or completed performance method of accounting. The Company records sales relating to these contracts using the proportional performance method when the Company determines that progress toward completion is reasonable and reliably estimable and the contract is long-term in nature; the Company uses the competed performance method for all others. Anticipated losses on contracts are recognized in full in the period in which losses become probable and estimable. Changes in estimates of profit or loss on contracts are included in earnings on a cumulative basis in the period the estimate is changed.

Revenue recognized related to product design and development services and related to the provision of engineering and design services is included in Engineering Modification and Development (EMD) revenue on the accompanying consolidated statements of operations.

The Company offers its customers extended warranties for additional fees. These warranty sales are recorded as deferred revenue and recognized as sales on a straight-line basis over the warranty period.

Warranty

Estimated cost to repair or replace products under warranty is provided when sales of product are recorded.

Income Taxes

Income taxes are recorded in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes* (SFAS 109), which principally utilizes a balance sheet approach to provide for income taxes. Under this method, the Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company s assets and liabilities. The impact on deferred taxes of changes in tax rates and laws, if any, applied to the years during which temporary differences are expected to be settled, are reflected in the consolidated financial statements in the period of enactment. A valuation allowance is established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. The Company files a consolidated United States federal income tax return (see Note 3).

Effective October 1, 2007 (the first day of fiscal 2008), the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. The Company has elected to record any interest or penalties from the uncertain tax position as income tax expense.

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Research and Development

Research and development charges incurred for product enhancements and future product development are recorded as expense as incurred. Product development and design charges incurred related to a specific customer agreement is charged to cost of sales engineering modification and development.

Comprehensive Income

Pursuant to SFAS No. 130, *Reporting Comprehensive Income,* the Company would be required to classify items of other comprehensive income by their nature in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. Comprehensive income consists of net income and there were no items of other comprehensive income for any of the periods presented.

Fair Value of Financial Instruments

The estimated fair value amounts of financial instruments presented in these consolidated financial statements were determined by the Company using available market information and appropriate methodologies. The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities. The carrying values of these assets and liabilities are considered to be representative of respective fair values based on pertinent information available to management as of December 31, 2008 and September 30, 2008.

Stock-Based Compensation

The Company account for stock-based compensation under SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award using an option pricing model. That cost is recognized over the period during which an employee is required to provide service in exchange for the award.

Concentrations

Major Customers and Products

For the three months ended December 31, 2008, four customers accounted 66% of net sales on a combined basis, the largest customer accounted for 30% and the other three each accounted for approximately 12% of net sales. For the three months ended December 31, 2007, one customer accounted for 71% of net sales.

Major Suppliers

The Company currently buys several of its components from sole source suppliers. Although there are a limited number of manufacturers of particular components, management believes other suppliers could provide similar components on comparable terms.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash balances and accounts receivable. The Company invests its excess cash where preservation of principal is the major consideration. The Company s customer base principally consists of companies within the aviation industry. The Company routinely requests advance payments and/or letters of credit from new customers.

The Company has maintained a reserve for doubtful accounts in the amount of $0 and $4.1 million, as of December 31, 2008 and September 30, 2008, respectively. The balance in the reserve for doubtful accounts at September 30, 2008 was directly related to accounts receivable from Eclipse Aviation, a customer that filed for bankruptcy under Chapter 11 subsequent to the Company s year end. During the three months ended December 31, 2008 the Company wrote off the Eclipse Aviation receivable.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides

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guidance on accounting for de-recognition, interest, penalties, accounting in interim periods, disclosure and classification of matters related to uncertainty in income taxes and transitional requirements upon adoption of FIN 48. The Company adopted FIN 48 effective October 1, 2007, which resulted in a decrease in the Company s other non-current liabilities for unrecognized tax benefits of $587,000 (including interest and penalties of $30,000 and a corresponding increase in shareholders equity.

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; however, the application of this Statement may change current practice for some entities. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption did not have any impact on the Company s financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-2, Effective Date of FASB Statement No. 157 which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis, at least annually, until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company does not expect the adoption to have any impact on the Company s financial statements.

In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements Amendment of ARB No. 51.* SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, changes in a parent s ownership of a noncontrolling interest, calculation and disclosure of the consolidated net income attributable to the parent and the noncontrolling interest, changes in a parent s ownership interest while the parent retains its controlling financial interest and fair value measurement of any retained noncontrolling equity investment. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008 (the Company s fiscal year 2010). The Company does not expect the adoption to have any impact on its financial statements.

In March 2008, the FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities.* The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance and cash flows. It requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity s liquidity by requiring disclosure of derivative features that are credit risk related, and requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is currently in the process of assessing the impact of the adoption of SFAS 161 on its financial statement disclosures.

In May 2008, the FASB issued SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles.* This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. This statement was effective on November 15, 2008. The adoption did not have any impact on the Company s financial statements.

2. Detail of Certain Balance Sheet Accounts

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market, net of reserve for excess and obsolete, and consist of the following:

	December 31, 2008	September 30, 2008
Raw materials	$ 3,927,421	$ 4,705,134
Work-in-process	2,496,918	3,046,451
Finished goods	1,243,902	1,609,672
	$ 7,668,241	$ 9,361,257

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Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	December 31, 2008	September 30, 2008
Revenue recognized not yet invoiced	$ 548,119	$ 747,789
Other	701,265	658,471
	$ 1,249,384	$ 1,406,260

Property and equipment

Property and equipment, net consists of the following balances:

	December 31, 2008	September 30, 2008
Computers and test equipment	$ 5,943,513	$ 5,879,362
Corporate airplane	3,082,186	3,076,400
Furniture and office equipment	1,074,029	1,074,029
Manufacturing facility	5,576,536	5,576,536
Land	1,021,245	1,021,245
	16,697,509	16,627,572
Less- Accumulated depreciation and amortization	(7,881,092)	(7,669,226)
	$ 8,816,417	$ 8,958,346

Depreciation and amortization related to property and equipment was approximately $217,000 and $237,000 for the three months ended December 31, 2008 and 2007, respectively.

Other assets

Other assets consist of the following:

	December 31, 2008	September 30, 2008
Intangible assets, net of accumulated amortization of $132,780 and $89,950 at December 31,2008 and	$ 246,220	$ 289,050

September 30, 2008, repectively				
Other		213,790		216,790
	$	460,010	$	505,840

Intangible assets consist of licensing and certification rights which are amortized over a defined number of units.

Total amortization expense was approximately $43,000 and $8,000 for the three months ended December 31, 2008 and 2007, respectively. Because the intangible assets are being amortized over a defined number of units, the future amortization expense over the next five years cannot be determined at this time.

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Accrued expenses

Accrued expenses consist of the following:

	December 31, 2008	September 30, 2008
Warranty (a)	$ 703,426	$ 736,815
Reduction in workforce / Severance (b)	594,164	904,163
Salary, benefits and payroll taxes	350,382	904,904
Professional fees	317,585	474,730
Materials on order	282,547	467,759
Income taxes payable	135,434	798,801
Other	429,350	843,291
	$ 2,812,888	$ 5,130,463

(a) The Company provides for the estimated cost of product warranties at the time revenue is recognized. Warranty cost is recorded as cost of sales and the reserve balance recorded as an accrued expense in the financial statements. While the Company engages in extensive product quality programs and processes, the Company s warranty obligation is affected by product failure rates and the related material, labor, and delivery costs incurred in correcting a product failure. Should actual product failure rates, material or labor costs differ from the Company s estimates, further revisions to the estimated warranty liability would be required.

Warranty cost and accrual information for the three months ended December 31, 2008 is highlighted below:

Warranty accrual at September 30, 2008	$ 736,815
Accrued expense for the three months ended December 31, 2008	78,010
Warranty costs for the three months ended December 31, 2008	